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I wish to file copies of a recently completed a book, *Foreign Investment in Telecommunications*, in the docket for the Commission's pending rulemaking in *Market Entry and Regulation of Foreign-affiliated Entities*, IB Dkt. No. 95-22.

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Sincerely,

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Foreign Investment in Telecommunications

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Revised Draft
October 20, 1995

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About the Author

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Mr. Sidak is co-author, with William J. Baumol, of *Toward Competition in Local Telephony* (MIT Press 1994) and *Transmission Pricing and Stranded Costs in the Electric Power Industry* (AEI Press 1995). He is the editor of *Governing the Postal Service* (AEI Press 1994). He has published articles on antitrust, telecommunications regulation, corporate governance, and constitutional law in the *Journal of Political Economy*, *California Law Review*, *Columbia Law Review*, *Cornell Law Review*, *Duke Law Journal*, *Georgetown Law Journal*, *Harvard*

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Mr. Sidak received A.B. and A.M. degrees in economics and a J.D. from Stanford University, where he was a member of the *Stanford Law Review*, and served as law clerk to Judge Richard A. Posner during his first term on the United States Court of Appeals for the Seventh Circuit.

Foreign Investment
in
Telecommunications

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Beyond America's Borders

MOST DEBATE over U.S. telecommunications policy during the 1990s has proceeded as though the known world ended at America's borders. Congress and the Federal Communications Commission have focused on statutes and regulations that inhibit competition among various categories of American telecommunications firms in the American market. That preoccupation is understandable given the central role in the U.S. of the breakup of the Bell System and the obsolescence of the Communications Act of 1934.

One byproduct of this inward focus, however, has been neglect by policy makers of how American consumers could benefit from the entry—in substantial part through foreign direct investment—of foreign telecommunications firms into the U.S. market. Needless to say, American policy makers have not considered that the American approach to telecommunications regulation may be producing demonstrably inferior results for consumer welfare than are the regulatory policies adopted in certain other developed economies since the privatization of their government telephone monopolies. This book is about these neglected but consequential issues in American telecommunications policy.

U.S. policy makers cannot ignore entry and investment by foreign telecommunications carriers any longer. In 1994, British Telecom (BT) received Justice Department and FCC approval to acquire 20 percent of MCI, the second-largest interexchange carrier (IXC) in the U.S.[1] The same year, Deutsche Telekom and France Telecom announced an investment of $4.2 billion to acquire 20 percent of Sprint, America's third-largest IXC.[2] These foreign firms would presumably invest even more in MCI and Sprint if not for section 310(b) of the Communications Act of 1934, which has the practical effect of capping at 25 percent the foreign ownership of an American telecommunications firm that is a licensee of radio spectrum.[3] Stated another way, in the absence of section 310(b), companies like MCI and Sprint would have greater freedom to accept foreign direct investment from additional overseas firms (such as Asian or Latin American carriers) whose participation in these global networks might be highly complementary to the participation of the initial foreign carriers whose direct investment in the American carrier by itself exhausted the 25 percent ownership allowed by the FCC.

For years, liberalization of the foreign ownership restrictions was unthinkable. Although, legal and economic analysis could readily expose the cost of the restrictions to American consumers, it was uniformly accepted in Washing-

1. Dept. of Justice, Antitrust Div., Proposed Final Judgment and Competitive Impact Statement: United States *v.* MCI Comm. Corp. and BT Forty-Eight Co., 59 FED. REG. 33,009 (1994); MCI Comm. Corp., 9 F.C.C. Rcd. 3960 (1995).

2. Andrew Adonis, *US telecoms alliance for France and Germany: Dollars 4bn stake in Sprint,* FIN. TIMES, June 15, 1994, at 1; Tom Redburn, *Sprint Forms European Alliance,* N.Y. TIMES, June 15, 1994, at D3.

3. 47 U.S.C. § 310(b)(4).

ton that the FCC and Congress were disinclined to liberalize foreign investment in telecommunications. Then, in 1994, perhaps because of the election of the Republican Congress, the political climate changed noticeably. In the discussion concerning the telecommunications deregulation bills in Congress in 1995, the question became how, not whether, Congress should relax the restrictions on foreign investment.

To answer the question of how Congress would best reform the foreign ownership restrictions, it is necessary to examine their origins nearly a century ago. The national security concern underlying section 310(b) is narrower than is commonly believed. The desire to limit the ability of foreigners to communicate by radio can be traced to the Russo-Japanese War and the race for naval superiority before and during World War I. Radiotelegraphy acquired even greater military significance during World War I because of the advent of submarine warfare. This concern over the national security implications of wireless led, shortly after World War I, to the creation and supervision by the U.S. Navy of the Radio Corporation of America, a private corporation holding critical patents over radio hardware. Only when RCA's patent monopolies expired and competition in international wireless became feasible in the U.S. in the late 1920s did Congress perceive the need to limit foreign direct investment in wireless in the U.S., enacting in 1934 the statutory provision now designated as section 310(b).

Nonetheless, refinements in encryption technologies soon vitiated the national security advantages that Congress expected section 310(b) to produce. The ineffectuality of section 310(b) was demonstrated only seven years after its enactment when, in 1941, Imperial Japanese diplomats readily transmitted encoded messages relevant to the imminent attack on Pearl Harbor from Washington to Tokyo over American-owned radiotelegraph carriers. Thus, even in the relatively simple technological era in which Congress enacted section 310(b), the foreign ownership restrictions failed to protect

America's national security.

In the six decades since enactment of the Communications Act, the statutory language of section 310(b) has been badly misinterpreted by the FCC and the courts. The FCC's reading of the operative provision of the statute is contrary to law and has contributed to a complex and costly process that competitors have repeatedly manipulated to impede the ability of foreign direct investment to make their rivals more potent competitors. Foreign direct investment is per se in the public interest, and the FCC should bear the burden of proof when asserting otherwise.

The regulatory esoterica that has resulted from the FCC's interpretation of section 310(b) has skewed business decisions for the structuring of ownership and control in American telecommunications firms. The foreign ownership restrictions do not apply to wire-based telecommunications. Despite the national security origins of section 310(b), network security and survivability are not now and never have been the focus of the statute. The restrictions consequently do not impair the ability of a foreigner to own wireline assets. Section 310(b) therefore distorts investment choices from wireless to wireline technologies and raises transactions costs. Nevertheless, foreign investors and American telecommunications firms can usually achieve their desired economic outcomes under the foreign ownership restrictions; but these economic actors must do so at an artificially higher cost than if the restrictions did not exist. Foreign investors, in other words, have been constrained to resort to inferior ownership and control structures to comply with section 310(b). The business structures that the FCC has considered permissible are unlikely to suffice as foreign direct investment takes place on a larger scale in transactions such as the alliance between BT and MCI or between Sprint, France Telecom, and Deutsche Telekom.

For an industry as large as it is, there has been relatively little foreign direct investment in the U.S. telecommunications industry. The nature of such investment is changing in a manner that makes global telecommunications networks more valuable to consumers and hence more essential as an organizational form for competitive telecommunications firms. Foreign direct investment is a predictable characteristic of the ownership and control of such global networks, a characteristic intended to reduce the monitoring costs in a joint venture composed of firms from different countries, cultures, and regulatory environments. Section 310(b), however, can act as a barrier to new entry or enhanced competition in the U.S.

There is a large and growing amount of American direct investment in foreign telecommunications firms. Such investment usually follows the privatization of a state-owned telephone monopoly and the opening of the market to competition. In this situation, American firms have invested not only in the incumbent carrier, but also in the new entrants, which typically are joint ventures involving a prominent local corporation that lacks technological and managerial expertise in telecommunications. Foreign direct investment of this sort benefits the shareholders of American telecommunications firms because overseas markets often have high profitability and rapid growth in demand. Of course, such investment also benefits foreign consumers (and perhaps also, as the result of network externalities, American consumers) by increasing competition and innovation in overseas markets.

Few informed persons today believe that concerns over national security continue to motivate the FCC's current enforcement of the foreign ownership restrictions. Instead, to the extent that section 310(b) is today anything more than a chauvinist device to keep foreigners from buying American companies in a particular industry, the statute has been appropriated as a crude tool with which to secure reciprocal market access for American carriers seeking to make direct investments overseas. In an attempt to refine that policy instrument, Congress has considered, in 1994 and 1995, repealing section 310(b) or amending it to provide specifically for the FCC to condition foreign investment on the existence of reciprocal market access for American direct investment in the telecommunications industry of the nation in question. Yet, there has been no effort to analyze the relative merits of repeal and reciprocity in light of the current economic literature on classical trade theory and strategic trade theory. Nor has there been any effort to use this body of economic thought to analyze the FCC's 1995 proposal to impose a reciprocity standard as an exercise of agency interpretation of its existing statutory authority under section 310(b). Economic analysis, however, shows that this proposed rule is counterproductive. Moreover, other government agencies have greater expertise to make trade policy, and it is unlikely that the FCC could replicate their expertise without considerable expenditures of time and resources.

Contrary to the usual assessment that outright repeal of section 310(b) would be politically naïve and counterproductive to the interests of U.S. telecommunications firms, the adoption of a reciprocity standard could easily harm American consumers and producers. Continued adherence to the FCC's traditional (but erroneous) interpretation of section 310(b) as imposing a 25 percent ceiling on foreign investment is likely to *reduce* market access for American telecommunications firms. Section 310(b) in its current form is unlikely to secure market access for American firms because it gives foreign governments a pretext for restricting American direct investment in their telecommunications markets. Repealing section 310(b) would be more likely to remove that pretext than would turning section 310(b) into an explicit reciprocity standard. Furthermore, given the abysmal experience of countless FCC policies that have regulated market entry since 1934, one can only expect that adding a reciprocity analysis to section 310(b) would encourage incumbent American firms to use the process to impede entry. That result would hardly encourage foreign governments to liberalize their restrictions on foreign direct investment in telecommunications.

Section 310(b) violates the First Amendment by restricting the ability of foreigners to speak through the electronic media or by restricting the ability of Americans to hear the views of foreigners. Under current constitutional law, different First Amendment analysis applies to the mass media than to common carriers. Content-based restrictions, however, receive strict scrutiny, and the recent News Corp. case involving Rupert Murdoch and the Fox Network illustrates how section 310(b) can be used in a way that is *not* content-neutral.[4] Under several different lines of analysis, the existing case law would support the conclusion that the foreign ownership restrictions violate the First Amendment. Furthermore, the Supreme Court's 1994 *Turner Broadcasting* decision[5] and its ruling expected in 1996 on Bell Atlantic's successful First Amendment attack on the cable-telco entry ban[6] may signal a sea change in the First Amendment protection of electronic speech generally. In the meantime, an embarrassing inconsistency exists between the FCC's interpretation of section 310(b) and the Supreme Court's 1990 analysis in *Metro Broadcasting*[7] of the importance of promoting diversity of ownership and diversity of expression. Consequently, in the name of protecting Americans from the threat of foreign ownership and control of broadcasting, the FCC has rebuffed attempts by Mexican and Taiwanese nationals to invest in radio and television stations planning to offer Spanish-language and Chinese-language programming to minority audiences in the U.S.

The U.S. must exercise leadership in reducing barriers to foreign direct investment in telecommunications. There are

4. Fox Television Stations, Inc., 10 F.C.C. Rcd., __, No. FCC 95-188 (May 4, 1995).

5. Turner Broadcasting Sys., Inc. *v.* FCC, 114 S. Ct. 2445 (1994).

6. Chesapeake & Potomac Tel. Co. of Va. *v.* United States, 42 F.3d 181 (4th Cir. 1995), *cert. granted*, 63 U.S.L.W. 3906 (June 26, 1995).

7. Metro Broadcasting, Inc. *v.* FCC, 497 U.S. 547 (1990).

five reasons why Congress should seek to do so by simply repealing section 310(b). First, as an exhaustive assessment of the legislative history makes clear, the statute no longer serves its national security purpose—if it ever did. Second, the statute, as interpreted and enforced by the FCC, has worked a result that is contrary to law and to sound public policy. Third, the statute denies American consumers the benefits of lower prices and more robust innovation that would flow from the full participation of the world's largest telecommunications firms in the U.S. market. Fourth, section 310(b) hinders American direct investment abroad; the statute thereby reduces American producer welfare and forecloses opportunities for the increased competitiveness of American telecommunications firms on a global scale. Fifth, section 310(b), as it has been applied by the FCC, unconstitutionally restricts the freedom of electronic speech. By repealing the foreign ownership restrictions, Congress would increase the likelihood that its efforts to enhance competition among telecommunications firms would bear fruit not only domestically, but also in the growing markets that extend beyond America's borders.

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The Legislative History

THE RADIO ACT OF 1912[1] is often considered the origin of the foreign ownership restrictions in the Communications Act of 1934.[2] In fact, the legislative history of such restrictions must begin with the outbreak of the Russo-Japanese War in 1904. The use of wireless communications by the Japanese Navy to crush the Russian Fleet ushered in a new age of communications awareness, elevating the strategic control of

1. Act of Aug. 13, 1912, ch. 287, § 2, 37 Stat. 302.

2. *See, e.g.*, *Hearings on Section 310 of the Communications Act of 1934 Before the Subcomm. on Commerce, Trade, and Hazardous Materials of the House Commerce Comm.*, 104th Cong., 1st Sess., 1995 FCC LEXIS 1423 (Mar. 3, 1995) (statement of Reed E. Hundt, Chairman, Federal Communications Commission); *Hearing on S. 253 before the Subcom. on Telecommunications of the Sen. Com. on Commerce, Science, and Transportation*, 104th Cong., 1st Sess. (Mar. 21, 1995) (testimony of Eli M. Noam); Ian M. Rose, Note, *Barring Foreigners From Our Airwaves: An Anachronistic Pothole on the Global Information Highway*, 95 COLUM. L. REV. 1188, 1188, 1194 (1995); Moving Phones Partnership L.P. *v.* FCC, 998 F.2d 1051, 1056 (D.C. Cir. 1993); John J. Watkins, *Alien Ownership and the Communications Act*, 33 FED. COMM. L.J. 1, 1, 4 (1980).

wireless communication to a paramount issue of national security. To secure this vital control, Congress, at the U.S. Navy's urging, imposed alien ownership restrictions on wireless communications companies operating within the U.S. to protect American military interests during time of war or international unrest. The scope of these alien ownership restrictions manifested itself to greater and lesser degrees during the defining regulatory periods of 1904 to 1912, 1912 to 1934, and 1934 to the present day.

Ironically, as a means to achieving national security, foreign ownership restrictions in U.S. telecommunications have been ineffective. While intuitively appealing, such restrictions were neither properly conceived nor well tailored to achieve their intended purpose—namely, control of the transmission of information vital to U.S. interests, particularly in time of war. In fact, restrictions on the foreign ownership of U.S. wireless companies were successful in limiting access to important radio hardware early in the twentieth century, but were largely ineffective in curbing the threats to national security from encrypted messages sent by foreigners over U.S carriers or the dissemination of alien propaganda. Indeed, as the history of governmental control over wireless companies in both World Wars documents, despite such alien ownership restrictions, Germany and Japan made use of American wireless communications systems to compromise U.S. national security.

With these considerations in mind, we will now trace the development of foreign ownership restrictions in the U.S. wireless communications industry, the degree to which national security and military concerns animated their implementation, and the failure of these restrictions in ultimately securing their strategic objectives.

Pioneers of the Ether

The earliest days of radio communications in the U.S. were typified by the sporadic deployment of this new technology by the military, by the military's persistent attempts to exclude amateur and commercial use of radio by civilians, and by the unwillingness of Congress and the Executive Branch to let the military succeed, other than in wartime, in monopolizing radio.[3] The U.S. Navy, for reasons discussed below, disliked the use of radio by *any* civilians, domestic or foreign. In time, the fact that some of the most logical companies to spearhead the commercial development of radio for civilian purposes happened to be British corporations would provide the Navy, through its recitation of national security concerns over foreign control of radio licensees, with a convenient way to slow the growth of civilian use of radio.

That the Navy proved to be the fulcrum upon which radio communications regulation in America turned is not surprising. Superior communications confers a strategic and often decisive advantage on a combatant. As early as the American Civil War, the Union army had strung telegraph wires from aerial observers in balloons, which, wrote General Ulysses S. Grant, created a communications network linking "each division, each corps, each army and . . . my headquar-

3. For historical analysis of this period, see JONATHAN W. EMORD, FREEDOM, TECHNOLOGY, AND THE FIRST AMENDMENT 138–45 (Pacific Research Institute for Public Policy 1991); ANDREW F. INGLIS, BEHIND THE TUBE: A HISTORY OF BROADCASTING TECHNOLOGY AND BUSINESS 28–56 (Focal Press/Butterworth Publishers 1990); SUSAN J. DOUGLAS, INVENTING AMERICAN BROADCASTING 1899–1922 (Johns Hopkins University Press 1987); LLEWELLYN WHITE, THE AMERICAN RADIO (University of Chicago Press 1971); ERIK BARNOUW, A TOWER IN BABEL: A HISTORY OF BROADCASTING IN THE UNITED STATES TO 1933 (Oxford University Press 1966); A. WALTER SOCOLOW, THE LAW OF RADIO BROADCASTING (Baker, Voorhis & Co. 1939); TYLER BERRY, COMMUNICATIONS BY WIRE AND RADIO (Callaghan & Co. 1937); GLEASON T. ARCHER, HISTORY OF RADIO TO 1926 (American Historical Society 1938; reprinted Arno Press 1971); CLINTON B. DE SOTO, TWO HUNDRED METERS AND DOWN: THE STORY OF AMATEUR RADIO (American Radio Relay League 1936). Many of the obscure original documents concerning the early regulation of radio are reprinted in DOCUMENTS IN TELECOMMUNICATIONS POLICY (John M. Kittross ed., Arno Press 1977) [hereinafter DOCUMENTS].

ters."[4] With the strategic implications of electronic communications in mind, the U.S. military (and more specifically the Navy) seemed a natural consumer of the emerging technology of wireless, which would enable ships at sea to communicate ship-to-ship and ship-to-shore. As Susan Douglas noted in her definitive history of radio, *Inventing American Broadcasting, 1899-1922*:

> To wireless inventors eagerly looking for customers, none seemed more promising than the U.S. Navy. Fresh from its victories in the Philippines and Cuba, and in the midst of a successful renovation and modernization, the U.S. Navy still lacked a critical tool: a reliable and versatile method of communications which could keep ships in touch with one another and with shore. Other navies were acquiring such a tool, and the United States Navy could not afford to fall behind.[5]

Thus, just as the U.S. Navy needed inventors and entrepreneurs to bring them wireless communication, so did these pioneers of the ether need the Navy—their largest, and most natural, potential client. This interdependence initiated the Navy's direct involvement not only in the development of wireless communication in the U.S., but also in the regulatory schemes that sought to restrict alien ownership of American wireless companies, culminating in the formation of the Radio Corporation of America. The history of this interrelationship is necessary to an understanding of the legislative history of U.S. telecommunications regulation, particularly with respect to the foreign

4. *Quoted in* R. ERNEST DUPUY & TREVOR N. DUPUY, THE HARPER ENCYCLOPEDIA OF MILITARY HISTORY: FROM 3500 B.C. TO THE PRESENT 900 (HarperCollins Publishers, 4th ed. 1993).

5. DOUGLAS, *supra* note 3, at 102.

ownership restrictions contained in section 310(b) of the Communications Act.

Reticence and Monopoly

Given the strategic importance of integrating wireless communication into the U.S. Navy's command-and-control structure, it is ironic that the Navy was at first slow to embrace the powerful technology of radiotelegraphy. The Navy's initial reaction to this emergent technology was a curious mix of reticence and fondness for monopoly. The Navy's reticence toward adopting this new technology was rooted in its traditional, if not anachronistic, conceptions of a captain and his ship. To the old Navy, wireless communication threatened the autonomy of a captain's command while at sea; and the captains treated wireless accordingly, either shutting it down completely once under way or simply ignoring calls from shore.[6]

The counterbalance to this antipathy toward wireless among naval commanders was their awareness of radiotelegraphy's enormous strategic potential and the perils of failing to assimilate this new communication technology. That awareness would increasingly manifest itself in a desire to monopolize wireless technology under direct naval control. Riven by these conflicting attitudes toward wireless communication, the Navy's early assimilation of radiotelegraphy was predictably equivocal. The Navy wanted to ignore this new technology and at the same time ensure that no one else could use it to superior strategic advantage. This untenable position ultimately collapsed upon itself, serving to impede not only the Navy's incorporation of wireless technology, but also the efforts of entrepreneurs trying to realize its full commercial and military potential.

6. *Id.* at 134.